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PUBLIC REGULATION OF RAILROAD ISSUES

A substantial economic warrant exists for the exercise of control by the state over the issue of securities by public service corporations. But grievous misconception prevails as to the exact way in which over-capitalization, so-called, really puts the public interest in jeopardy. Aside from the losses to private investors, what, in point of fact, are the evil consequences to be feared and averted? The prevalent view underlying most anti-stock-watering legislation is that the prevention of over-capitalization is incidental to the making of reasonable rates. This was peculiarly true in the early days before the courts evolved the doctrine of the fair value of property as a basis for charges. In this connection stock-watering impinges upon physical valuation.[1] It seems to be true that, although the connection between capitalization and rates is not immediate, the volume of outstanding securities may oftentimes be indirectly a factor of considerable moment in rate making. But there is a far more weighty plea in the public interest for the prevention of unwise financing.

The strongest argument against over-capitalization is that it tends to interfere with proper maintenance—with the making, that is to say, of needed improvements and the rendering of satisfactory service. This is frankly conceded nowadays by official spokesmen of the carriers themselves.[2] Public interest in this regard merely confirms the dictates of business prudence, in the demand that a corporation should always hold itself in readiness to issue stocks or bonds advantageously in case of need. This it certainly cannot do, except under prohibitive penalties, if its bonds stand at heavy discounts and its stocks are quoted at merely nominal figures. This point cannot be too strongly emphasized. It is not primarily that the public suffers, as a result of over-capitalization, because a railroad is unable to pay a re-

[1] *Cf.* Ripley, "Railroad Valuation," *Political Science Quarterly,* XXII (1907), p. 600.

[2] *Railway Age Gazette,* LVI (1914), p. 61.

turn on all its outstanding securities without raising rates; but that interest and dividends may for a while be paid by the diversion of earnings which ought properly to be spent on maintenance and improvements. However the matter be viewed, it is the effect of over-capitalization upon maintenance, development, and adequate service, and not its effect upon the level of charges, which should occupy the forefront of the argument.

See how things work out in practice! The expropriation of the surplus of the poor old Alton road[3] may or may not have affected its ability thereafter to charge higher freight rates than its competitors. However that may be, the fact that the treasury was so completely gutted that the Rock Island interests, on taking over the property, were compelled at once to issue equipment notes at ruinous rates in order to do any business at all, was the feature of public concern. All experience confirms this view. Consider the utter break-down of service in New England in 1912-1913, the intolerable delays and appalling accidents, as a result of the New Haven collapse. It was because all financial resources had been dissipated in seeking "monopoly at any cost," that not a penny remained, or could be raised, for the real business of transportation. Or, if you please, consider the metropolitan traction companies in New York.[4] Millions of dollars were lost through the knavery of their managements; but fares remained at five cents throughout. Where the public suffered was through the pitiful collapse of the service. Despite the fact that the maximum life of street railway equipment was ten years, the surface roads made practically no allowance for depreciation from the organization of the Metropolitan Street Railway in 1893. For five years preceding the receivership not a new car was bought; and it was beyond the power of the company to buy. So completely had every resource been exhausted that funds were not to be had on any terms in order to put the service on its wheels. In brief, it was the collapse of the service attendant upon financial prostration due to stock-watering, which aroused public opinion and led to reform. To protect the standard of service in this way is, perhaps, even more vital an element in governmental policy than everlasting insistence upon reasonable rates. When service collapses, unlimited losses amounting to total confiscation fall upon

[3] Details by the author in *Political Science Quarterly,* XXVI (1911), p. 106 *et seq.*

[4] *Cf.* footnote p. 545, *infra.*

the community. Unreasonable rates may take a part, indeed, but never the whole.

Public policy in the matter of protection of common rights with regard to rates and service and of the interest of investors in the domain of railroad finance may assume either of two forms. The more modest one relies upon mere publicity as a safeguard against abuse. The other, more radical in type, seeks positively to regulate the amount and nature of the securities issued and thereby to exercise a strict and definite control over every detail of financial management. In view of the imminence of legislation by both the United States and Canada in this field, it is important to understand the advantages and limitations of each of these plans.

Strict and complete publicity, without further specific regulation, is the policy ably advocated by the federal Railroad Securities Commission of 1910.[5] This body held that too much stress was being laid upon "keeping down the nominal amount of stock, and too little upon getting the actual amount of capital needed and having it properly used." Emphasis was also laid upon the ease with which such state statutes might be evaded. Moreover, it was repeatedly urged that the federal government in seeking to standardize railroad finance must beware of the appearance of a guarantee of quality. As phrased by the Railroad Securities Commission (1911):

> We are told that if it was possible to standardize food by a pure food law, it ought to be possible to standardize railroad securities by a securities law. It is possible—to the same extent and no more. The pure food law enables a man to know what he is buying. It does not certify that the thing he buys is good for him. That is left to his intelligence. The government cannot protect the investors against the consequences of their unwisdom in buying unprofitable bonds, any more than it can protect the consumers against the consequences of their unwisdom in eating indigestible food.

The importance of this warning, that not even an implied guaranty of securities approved for issue follows their certification by a public commission, is found in the embodiment of such a disclaimer in all of the newer public service commission laws.[6]

The two general policies, mentioned above, as to the duty of the government in creating corporations—first, the older view that,

[5] Ripley, *Railroads: Rates and Regulation,* p. 573.

[6] *Commission Regulation of Public Utilities,* compiled by the National Civic Federation, New York, 1914. *Cf.* evidence for the I. C. C. before Senate Committee on Interstate Commerce, June, 1914, on the subject.

being creatures of the state, they should be guaranteed by it to the public in all particulars of responsibility and management; and the modern, quite opposite theory that, in the absence of fraud, an ordinary business corporation should be given a wide latitude in matters of organization and government—are admirably contrasted by the Massachusetts Committee on Corporation Laws of 1903.[7] The attendant revision of corporation law in this state marked a turning point in policy. The modern theory was accepted, that for ordinary business corporations the state owes no duty beyond providing clearly that creditors and stockholders shall at all times be accurately informed of all facts attending both organization and management. Such, likewise, is the policy adopted by modern European states with respect to private corporations.[8] Great interest in this field of late is shown in the passage since 1908 by no fewer than eighteen American commonwealths of so-called "blue-sky" laws.[9] These statutes seek, in the main, the protection of unwily investors against fraudulent promotion; but their significance for us at this time lies in their avowed acceptance of the policy of complete publicity. With that, however, they are thus far content.

Is a passive policy of mere publicity in matters of finance, being thus more and more applied to ordinary corporations, adequate for dealing with railroads and other public service companies? The answer, so far as our separate state governments are concerned, is found in the action already taken during the last few years. For a long time Massachusetts and Texas stood alone in dealing with railroads by a more positive program of strict financial regulation. Their experience is reviewed later.[10] But since 1908, partly as a result of activity by the federal government in rate regulation, no fewer than thirteen other states have followed in their train and have set up public service commissions of one sort and another.[11] Unlike the federal govern-

[7] Ripley, *Trusts, Pools and Corporations,* ch. 15.

[8] *Ibid.,* pp. 393-428, on England and Germany.

[9] Arthur N. Ayres, "Governmental Regulation of Securities Issues," *Political Science Quarterly,* XXVIII (1913), pp. 586-593.

[10] On state commissions in general, *cf.* Ripley, *Railroads: Rates and Regulation,* ch. 20.

[11] The thirteen states which have recently embarked upon such financial regulation, in addition to Massachusetts and Texas, are New York, Ohio, Missouri, Indiana, New Hampshire, Michigan, Wisconsin, Nebraska, Kansas, Arizona, California, Vermont, and New Jersey. For details consult *Commission Regulation of Public Utilities,* ch. 12.

ment, these states have not been content to stop at rate regulation or even supervision of operation. They have all extended their authority over financial matters as well. These new powers of regulation seem to be intended less for the immediate protection of capital than for the attainment of reasonable charges and satisfactory service. In outline, the laws define the issue or exchange of securities as the exercise of a special privilege calling for a formal license from the state. Such authorization is given only after public procedure in order to ascertain: (1) the amount and character of the expenditure, that is to say, the exact purpose for which the new securities are to be issued; (2) the public necessity or advantage of such action; and (3) the precise terms of the offering, together with the effect upon the financial status of the corporation.[12] Formal proof in these matters is followed by permission to issue the securities. And such authorization must in due time be succeeded by certification that the details of the prescribed program have been duly observed.

The experience of New York in regulating capital issues is most illuminating—because of the magnitude of the interests involved; because, unlike the western states, financial rather than rate regulation has been the main object of interest; and because of the exceptional ability and intelligence of the members of the administrative boards. For many years the old railroad commission had been an utter nonentity, abjectly subservient to the powerful railroad and trolley companies. In 1893 just before the formation of the Metropolitan Street Railway, when, for some reason, the commission refused its approval of a $6,000,000 stock increase of the Pavonia Ferry road, Thomas Ryan and his friends had the securities printed just the same and then exchanged them for a like amount of Metropolitan Street Railway stock.[13] To this high-handed proceeding the railroad commission interposed no objection. Under the initiative of Governor Hughes, two separate

[12] The necessity of strict definition of such delegated legislative powers arises from judicial decisions to the effect that without specific rules for the guidance of an administrative board in exercising control over the issue of securities the statute is unconstitutional. (*State* v. *Great Northern Railway* (1907), 111 N. W. Rep. 289.)

[13] The details of Metropolitan Street Railway finance are contained in the first four years' reports of the First District Commission. They are also reviewed in a series of articles by H. A. Bullock in the *Boston Transcript,* Oct. 3-14, 1908; in *McClure's Magazine,* Nov. and Dec., 1907, and Jan., 1908; and *Annals Amer. Acad. Pol. Science,* XXXI, pp. 535, 612.

public service commissions were created in 1907, one having jurisdiction over corporations within the First or metropolitan district, the other, with headquarters at Albany, being charged with responsibility for the rest of the state. It is this Second or up-state commission which has mainly had to do with railroads; but the same principles have been involved in supervising the financial operations of the public service companies in New York City. Some measure of the restraint exercised by the metropolitan commission may be gathered from the fact that, within four years from its creation, only $89,000,000 out of a total of $307,000,000 requested by the companies was approved. As for the up-state commission, within the first six years it authorized the issue of $439,890,000 of bonds and $50,820,000 of stocks by railroad companies alone.[14] Within this time, practically every railroad in the commonwealth appealed to it for allowance of security issues for almost every conceivable purpose. The experience though brief is certainly most significant.

Concrete cases best describe the New York practice in improving and standardizing public corporation finance. In the field of railroad building, a bar is set against the classical abuses and financial manipulation.[15] Capital accounts must be closed when building stops. Operating expenditures may not be capitalized even for a brief period; nor is allowance for experimentation at the expense of the public permitted.[16] Insistence upon a clear distinction between capital and income account which lies at the

[14] *State Regulation of Public Service Corporations in the City of New York* (P.S.C. 2d D., statement of Sept. 1, 1911), p. 45; 1 P.S.C. 2d. D.(1912) 113. Securities may not be authorized for more than one year without the approval of the commission and then only for: (1) acquisition of property; (2) construction, completion, or extension of facilities; (3) improvement or maintenance of service; (4) discharge or lawful refunding of obligations. In other words, three distinct purposes are contemplated: investment for the future on capital account; reimbursement of past expenditure on capital account; and refunding of obligations. The *Seventh Annual Report* of the up-state commission (p. 100) succinctly summarizes the main principles of its capitalization policy.

[15] Described by the author in *Railway Age Gazette*, LVI (1914), pp. 1177, 1225.

[16] 3 P.S.C. 1st D. 63. In this field of construction finance the admirable review in Whitten's *Valuation of Public Service Corporations* outlines the policy. Allowance is made for expenses of promotion (p. 265); for working capital (p. 296); for interest during construction (p. 258); for contractors' profits (p. 248); and for general overhead charges such as engineering (p. 229). But capitalization of early losses is not permitted (p. 551). *Cf.* the opposite policy in Wisconsin; 10 Wis. R. C. Rep. 872; and New Jersey, *infra*.

foundation of all sound financing, is continued throughout. In the second place, the issue of securities in order to pay for mere replacement of property has been severely condemned in a number of instances. The Lehigh and Hudson River road in 1909 was thus forbidden to sell bonds in order to reimburse its treasury for payments not properly chargeable to capital. On the other hand, expenditures made for investment in the property from income may with entire propriety—and, since amendment of the law in 1910, legally as well—be paid for through the issue of stocks or bonds. The Erie, in 1912, having satisfied the commission that within five years it had spent $12,000,000 out of earnings upon its property, was permitted to capitalize it.[17] As to whether non-revenue-producing expenditures, such as abolition of grade crossings, should be entirely capitalized, is a nice question depending upon one's view of the nature of surplus revenue.[18] The up-state commission, noting a disposition to meet all such expenditures through the sale of securities, has wisely declared that the tendency "should be checked and repressed" in the interest of conservative finance. As to the dangerous plan of paying for improvements through the creation of a floating debt, the New York boards are in accord with the federal Securities Commission in condemning it flatly.

Another group of New York cases are concerned with the issue of securities in connection with consolidation. In the wide field of public utilities it doubtless appears in the public interest to permit a strong concern with low operating costs to absorb small, weak, or otherwise handicapped competitors. Yet the price paid for purchase is a vital element to be considered. The up-state commission in such matters adheres to the prudent plan of requiring amortization of the difference between the inventory cost of the physical property acquired and the price actually paid. The Delaware and Hudson case in 1908 showed the necessity of curbing the tendency to water the stock of a strong company through the purchase of subsidiaries at exorbitant figures. This railroad requested authority to issue bonds in order to take up notes representing acquisition of the Hudson Valley Railway together with certain undeveloped coal properties. Investigation revealed a good deal of scandal associated with the purchase of these properties prior to the creation of the commission. The original

[17] 1 P.S.C. 2d D. (N. Y., 1912) 238.

[18] *Quarterly Journal of Economics,* Aug., 1914.

transaction was a thing accomplished. The up-state commission had no power to change ownership or to review the expediency of issuing the original notes; but it positively declined to permit long-time bonds to be issued, on the ground that the properties covered by the mortgage were inadequate as to both intrinsic worth and earning power. The case went in the following year to the Court of Appeals which limited the commission's power through the declaration that the legislature had not intended to make this administrative board the financial manager of corporations or to empower it to substitute its judgment and discrimination for that of the directors or stockholders.[19] So much for power to correct misdeeds in the past. But a closer reading of the opinion affirms the inherent right of the commission to prevent the recurrence of such abuses in the future.

Quite similar is another case which has recently been closely contested before the New York courts.[20] The New Haven railroad, it appeared, had paid over $900,000 in 1912 for a trolley line which the commission found to be actually worth only $400,000. It consequently limited the amount of New Haven stock which might be issued in payment therefor. The lower court held that whatever the property cost was controlling upon the commission, unless actual fraud was proven. But this opinion was unanimously reversed by the Court of Appeals in the first New York decision holding that cost of property is not necessarily a controlling factor in capitalization. There was no question of good faith involved, inasmuch as two powerful rivals were bidding against one another at public auction.

The payment of dividends from capital has likewise been prevented by the rulings of the New York up-state commission. The record in this regard showed a slight disposition to wobble; but, in the main, the policy was sound. The leading decision concerned the right of the Erie, in 1909, to pay a script dividend to meet its interest requirements. The commission by a divided vote in the preceding year had permitted this company to stave off a threatened receivership by issuing bonds to anticipate several years' interest payments, on condition that a like amount should be put back into the property during the period in question, out of earnings. Fears were entertained, in view of the absence of positive guarantees by the railroad, that a sound and conservative policy

[19] 197 N. Y. 1; a precedent followed by Nebraska in 1912 in *Fifth Ann. Rep. Railway Commission,* p. 177.

[20] 158 App. Div. 251; reversed in 210 N. Y. 456.

was in jeopardy. But a subsequent decision prohibiting a stock dividend of 80 per cent for "property and services," as a cover for largely increased earnings and in order to distribute previous depreciation credit and surplus, manifested adherence to the only wise course to be allowed.[21]

The distinct issue of corporate reorganization, with its attendant increase of securities or perpetuation of preceding excessive issues, has not in the railroad field directly engaged the attention of the up-state commission. But the protracted struggle in the Third Avenue Street Railway case[22] shows that the metropolitan commission from this viewpoint also has taken its responsibilities seriously. The closest analogy, indicating the attitude of the up-state commission, is that of the Watertown Electric Light Company in 1909. The commission apparently refrained from an unduly drastic policy in scaling down securities.[23] Unlike Texas, soon to be reviewed, the policy pursued did not seek to undo at one fell stroke a long course of financial excesses in the past. Nevertheless, a wholesome restraint and corrective was applied so far as practicable.

It will be observed that the same broad question is raised in both merger and reorganization cases as to the proper function of public regulation. Is it to be limited to present and future action, or is it to be retroactive in effect, seeking to correct or compensate for financial excesses in the past? It is evident that an attempt to disentangle these successive periods of time is a matter of the utmost difficulty. The results of men's misdeeds generally long outlive them. And yet impatience in seeking to undo the past at once may result in as grave inconvenience and injustice as neglect to consider it at all. This follows from the well-known principle that financial excesses are bound sooner or later to be reflected in corresponding market quotations for the securities. Innocent holders for value, considered in connection with the substitution of new securities for old under reorganization proceedings for example, may or may not already have incurred heavy losses through depression in price of their securities. One

[21] Bronx Gas and Electric Light Co. (1909), case no. 1160.

[22] *Quarterly Journal of Economics*, Aug., 1914.

[23] *Cf.* the Binghamton case (203 N. Y. 22 [1907]) where it was held that the commission had no power to permit an issue on condition that certain outstanding stock be cancelled; but that it could merely be determined whether the proposed issue was in accordance with the statute. *Cf.* the Fall River Gas Co. case (1913), 214 Mass. 529.

point is, however, clear—that the sooner a corrective policy, aiming to place the company upon a firm and substantial footing, is adopted, the sooner may the healing forces of nature bring about some measure of restitution.

In several respects the New York commissions have been more liberal, and perhaps wisely so, than those of Massachusetts and some other states. There has been steady insistence from the outset, as in the Interborough Rapid Transit case, upon public offerings of all securities, to the end that the companies may realize the largest possible amount from their financing. But, as we have already seen, the issuance of stock below par and, when necessary, of bonds at a discount has been allowed—the commissions being contented to provide the necessary safeguards through amortization within a reasonable period. The contrast with Massachusetts policy in these respects will soon appear. The extended experience of the metropolitan commission with the New York City Railway has led, however, to a rigid prescription of the manner in which discounts shall be handled in all such cases.[24] Neither the public nor investors may longer be deceived by an item in the balance sheet of "Construction and Equipment $5,000,000," believing it to be a good asset; when, as a matter of fact, $4,500,000 of this sum was discount on notes sold at 70 and redeemed at par within three months. Comparative liberality of policy in New York also appears in the allowance of bond issues to provide working capital and promotion and development expenses.[25] Restraint has also been imposed for the protection of minority stockholders, as in the refusal to permit the lease of the Ontario and Western by the New York Central.[26] And, finally, in the matter of refunding, the New York commissions have in various instances permitted the issuance of the new securities, but only when guarantee was offered, though giving more ample security, that the new bonds, if issued at par, should at least approximate their seeming worth.

The foregoing instances by no means cover all the details of these complicated proceedings, even in outline; but they at least afford evidence of the necessity for close supervision both in the public and private interest, and of the highly satisfactory manner in which the responsibilities imposed by the law in New York

[24] The commission regulates more largely through rigid accounting rules, aiming to prevent any capitalization of discounts.

[25] New Jersey is even more liberal, as will soon appear.

[26] 3 P.S.C. 2d D.(1913)261.

have been met. The spirit actuating the service is well summed up in the following quotation from a recent report:

> While the commission does not, in making authorization of securities, in any way guarantee that the securities so authorized are a good investment, yet it is earnestly endeavoring to bring it about that the financial statements on the basis of which such securities are sold may be such that the investor will not be misled.

It is thus apparent that the features of complete publicity and strict regulation are esteemed to have equal weight under the New York law and practice.

It is broadly significant also that in New York state the experience has been quite parallel to that of the United States in respect of conflict of authority between the administrative and the judicial branches of the government.[27] The carriers in both instances have sought refuge from decisions of the commissions in restraining orders of the courts. A notable instance now in controversy is afforded by the New York Central Commutation Rate case. The commission ordered certain reductions in fares, from which appeal was promptly taken to the appellate court. In January, 1914, a decision was handed down annulling the order on the ground that the real merits were not passed upon. The inevitable result followed. Resort was promptly had to the legislature, which responded to local pressure and passed a special bill re-instating the rates annulled. This is the lesson of experience everywhere. Until the courts cease to hold it to be their function to review such cases on economic grounds and in the broadest way, the legislature is debarred from vesting full responsibility in the agent to whom it has delegated legislative power. Resort to special legislation is bound to follow adjudication of this character. It is certainly to be hoped that the New York Court of Appeals will follow the precedent laid down in the Illinois Central decision in 1910 by the Supreme Court of the United States.[28]

The experience of Massachusetts in seeking honest capitalization by law is significant in several respects.[29] It reveals the possibility of too great strictness in financial regulation, or rather

[27] Ripley, *Railroads: Rates and Regulation,* ch. 14.

[28] *Ibid.,* p. 538.

[29] The following references will be found serviceable: Ripley, *Trusts, Pools and Corporations,* 1909, pp. 121-148; C. J. Bullock, *Pub. American Economic Association,* 3d series, X (1909), pp. 384-429; *Quarterly Journal of Economics* XXII (1908), p. 640. A good historical summary will be found in the Fall River Gas Co. case, 214 Mass. 529.

misplaced strictness in focusing attention upon the issue price rather than upon the provision in proper ways of an adequate supply of capital for the needs of the service. It also emphasizes the need of elasticity in procedure—not governing, that is to say, through rigid statutory rules; but, after laying down the law in general terms, giving play for the exercise of discretion in its application. Yet while defective for a time in these respects, no impartial student can deny that the effect of this Massachusetts legislation has on the whole been salutary. Had the New Haven system in its degenerate days before 1913 been subject, in fact, to as strict regulation under the laws of Connecticut as Massachusetts sought to impose, the disaster might never have occurred.

The best evidence of the soundness of this legislation at bottom is found in the statistics of capitalization of street railways. The steam roads are so largely interstate that comparisons are impossible. Connecticut until 1913 gave absolutely free rein to its trolley lines. Massachusetts held them in check. The average capitalization of street railways in Connecticut in 1912 was $115,810 per mile of line. The corresponding figure for Massachusetts, including the Boston elevated system and its other costly city lines, was only $63,300—practically one-half the Connecticut figure.[30] In other words, taking Massachusetts as a standard, over-capitalization in Connecticut was about $52,500 per mile. Such evidence is conclusive as to the benefit of restriction. But the point may, nevertheless, be carried forward that it is possible to overdo a good thing.

The Massachusetts policy has been mainly concerned with fixing the issue price of capital stock, because of the circumstance that the New England roads have been so largely financed by this means. Bonds have played a relatively subordinate role. The aim has always been to limit the issue of securities to the *bona fide* investment of capital. The issue of stock merely as a bonus to promote the sale of bonds has never been tolerated. The lines of this legislation were for the most part laid down in the early days, when financing by subscription to share capital was everywhere the rule. Most of this stock, moreover, was sold in the beginning at a fair percentage of its face value. As a result, with the demonstrated success of the enterprise, stocks steadily rose above par instead of merely approaching it, as has been the case in other

[30] *Railway Age Gazette*, LII (1912), p. 15-32. *Trusts, Pools and Corporations*, p. 127, gives additional data for international and state and city comparisons in 1899.

parts of the country where share capital had at the outset no real worth. The main effort in Massachusetts, then, for many years, was to divide fairly the premium on new shares between the stockholders and the public. This task was imposed upon the Railroad Commission, which, while having only advisory powers in matters of rate making since 1869, was given full authority in the sphere of regulation of the issue of securities. But a review of the experience seems to indicate too microscopic attention to the mere matter of issue price, to the neglect of the broader issues of financial policy, such as charges to depreciation, the relative proportion of stocks and bonds, and the insistent demands for new investment in plant for the sake of the service.

The cardinal principle at law in Massachusetts has been to require that no securities of public service companies shall be issued except for cash and at not less than par value. The wisdom of the general plan is almost universally recognized; but the practical means of attaining the desired end without unduly hampering enterprise, have varied from time to time. The first plan, before 1871, was to prohibit all issues of stock except at par. This was manifestly unfair both to the corporation and to the public. It often deprived the former of whatever premium the stock would command at public sale; and it sometimes permitted distribution of an accumulated surplus by means of excessively valuable subscription rights. The second plan, in effect from 1871 to 1878, was to require that all new shares should be sold at public auction.[31] This was perhaps borrowed from the long-standing English custom of "auction clauses," requiring gas companies to put forth their securities in this way. But this violated the traditional rights of stockholders to preference in all such transactions. Moreover, it opened the way to contests for control between rival interests, which violently disturbed market prices. At this point in 1893, came the illuminating experience with the Connecticut River road, elsewhere set forth.[32] This led to the anti-stock-watering law of 1894, prohibiting the issue of share capital at other than the market value, this value to be ascertained by the Railroad Commission.

The Massachusetts law of 1894 undoubtedly restrained the issue of watered stock. Shares were issued under it in some cases

[31] As early as 1877 the Railroad Commission applied the principle "although with considerable hesitation" that capitalization should not exceed the value of the tangible assets minus the liabilities. (*Reports,* 1877, p. 127.)

[32] *Quart. Journ. Econ.,* Aug., 1914.

at premiums as high as $90. The Boston and Maine road put forth new shares at different times at $190 and at $165 in cash. Street railways to 1908 applied 207 times for increases of capital. In 54 instances a premium was prescribed; in 153 the emission was at par. As I have stated elsewhere:[33]

> The plan worked well as long as investors were in optimistic mood. And it happened that throughout the following decade, to 1903, the trend of market prices was steadily and sometimes strikingly upward. In consequence, shareholders almost immediately realized profits from subscriptions even at these high prices. To be sure, a very difficult task was imposed upon the railroad commission—that of determining in advance what the price would be after the new issue had been made. It was largely a matter of guesswork, and instances occurred in which "rights" were transferred into losses. Moreover, as was urged by the companies affected, this process of emitting shares at various prices introduced great inequalities as between different shareholders, in respect of the rate of return upon their investment. To the stockholder who subscribed at $190 per share, dividends at the rate of eight per cent obviously yielded only about one half the rate of return which accrued to the old subscribers at par. In the determination of the reasonableness of general rate schedules, it was held, this would greatly embarrass both the legislature and the courts. Other details of this legislation were found to work hardship in practice; such as the limitation of bonded debt to the par value of the share capital (which still left the door open to the creation of heavy current liabilities), and the prohibition of stock issues to cover promotion expenses or to provide working capital. With the panic of 1903, the unduly drastic character of the law became plainly apparent. Funds for development could scarcely be raised at all. One important company was obliged to borrow on its short-time notes at eight per cent, because of inability to market its stock at the high premium fixed by the railroad commission. Nor could it issue bonds, because of the limitation of indebtedness to the outstanding share capital.[34]

Conceding fully the desirability of sharing between the public and the corporation the benefits of a premium upon the issue of new stock, a special commission recommended a more liberal policy. Limitation of the rate of return upon investment to what was practically a savings-bank rate had dried up the sources of capital for improvement. The new law of 1908 amended the system by permitting new shares to be offered for subscription at a price not less than par, to be determined by the stockholders subject to the approval of

[33] *Political Science Quarterly,* XXVI (1911), pp. 120-121.

[34] Increased to double the capital stock in 1913 as the price of permitting the creation of a new public service commission, as seen below.

By new legislation in 1909, capitalization for working expenses was allowed; and the Boston Elevated issued $1,000,000 bonds for the purpose in 1914. A bill is now pending to permit capitalization of replacement outlay.

the railroad commission.[35] The control of the state is still supreme, but an opportunity is offered for such liberality on the part of corporations and their shareholders as shall insure the success of their issues. Premiums of $25 per share, carrying rights worth as high as $5, have already been allowed.

The objection to this more liberal policy, vehemently urged, was that in times of abounding prosperity, stockholders might be tempted to fix prices of emission so low as practically to entail stock-watering. But the reservation of power to disapprove of these terms appeared to be a sufficient safeguard.[36] It was generally recognized as a result of this varied experience that both public and shareholders had rights which must be respected. Complete freedom of issue leads to inflation. Too drastic restriction dries up the springs of capital upon which the public must depend for future development. A wise course lies intermediate between the two. The decline and fall of the New England railroads in 1912-1914 has stood in the way of any decisive test of the latest principle adopted. And the entire reorganization of the old railroad board, in 1913, creating a new public service commission, has brought both powers and procedure more nearly into line with the practice of New York and the other American states.[37] The old advisory railroad commission of 1869 was transformed after forty-four years into the present administrative board which differs little from that of New York. This legislation, however, afforded a most disquieting evidence of the power of a railroad lobby. Despite the incisive campaign waged by Governor Foss for three years, the New Haven Railroad demanded and, as the price of its consent, received a clause enabling railroads to issue long-time securities up to *twice* the amount of their outstanding capital stock. This iniquitous provision runs counter to all the dictates of business prudence. What will happen as a result remains to be seen.[38] At the same time, in the matter of rates, mandatory rather than recommendatory powers were in general conferred.

[35] The liberalization of the general corporation law at the same time is discussed in *Quarterly Journal of Economics*, XVIII, pp. 269-280; reprinted in *Trusts, Pools and Corporations*, pp. 382-392.

[36] The law was construed in the *Fortieth Annual Report of the Board of Railroad Commissioners* of Massachusetts, p. 155, as follows:

> The phrase "so low as to be inconsistent with the public interest," undoubtedly difficult of exact definition, must, in connection with the legislative act of 1908, be taken to mean in any specific case *an issue price materially* lower than a price which would assure a ready market for the issue.

[37] *Quarterly Journal of Economics*, XXVII (1913), p. 699.

[38] *Cf.* p. 560 *infra*.

The regulation of railroad capitalization in Texas under its so-called Stock and Bond law of 1893 is instructive especially when taken in connection with the experience of Massachusetts, just described.[39] Both states strictly forbade the issue of new securities without approval by public authority. But the motives, as reflecting differences in the local situations, were strikingly contrasted. Texas was mainly interested in the regulation of rates at the start. Massachusetts had an eye to the welfare of investors. But both alike since that time, as we shall soon see, have come to recognize that the main consideration in regulating security issues is to safeguard the character of the service. Texas, then an undeveloped country, was newly berailroaded by companies heavily over-capitalized as a result of optimistic promotion. In Massachusetts, on the other hand, the stock-watering operators were, so to speak, "accessories after the fact." New England roads had originally been most conservatively built. Few, if any, bonds had been issued. Stock had been paid for in full at par. The threat of an overload of securities as compared with the growth of earnings appeared late in the life of the companies.[40] In this densely populated territory the increment in land valuations and especially terminals had probably brought assets to more than an equality with the volume of securities outstanding. But it had become evident that without restraint stock-watering in future might take place in order to provide a broader basis for distribution of increased earnings. Texas, on the other hand, was endeavoring to "squeeze the water" from its roads, already heavily over-capitalized in connection with construction. In other words, Massachusetts was applying a close-fitting straight jacket to full-grown corporations in order to prevent future violence; while Texas sought to withhold youthful and bumptious companies from making engagements for the future until they had grown to the measure of the financial garments already on their backs. But whatever the motive in either case, the Texas experience confirms that of Massachusetts in the demonstration that it is possible to overdo a good thing; to be too rigid and strict in pursuance of a normally laudable policy; and that not all the mistakes of two generations past can be corrected in the twinkling of an eye by means of a statute.

[39] The best references from opposing points of view are as follows: *Texas Academy of Science,* Presidential Address, 1902; *Quarterly Journal of Economics,* XXII (1907), pp. 109-119; *Bull. University of Texas,* No. 236 (1912), pp. 83-120.

[40] P. 553 *supra.*

The Texas Stock and Bond law of 1893 declares that the power and authority of issuing or executing bonds or other evidences of debt and all kinds of stock and shares are special privileges and franchises; and that the right of supervision and control is vested in the state. It is specifically provided that "no bonds or other indebtedness shall be increased or issued . . . over or above the reasonable value of said railroad property": although in case of emergency, bonds and stocks may be executed to an amount not exceeding 50 per cent of the valuation. Under this Texas law, therefore, it is evident not only that all bonds must be authorized and approved but that they must be actually registered. No further issues may take place until all previous over-capitalization has been expunged. Such obliteration may take place either by reinvestment of earnings in the property, or else through gradual appreciation of assets due to the growth of the country. For, under the law, valuation being based upon the cost of reproduction, donated property, such as land, may be inventoried at present or prevailing prices. In the administration of this statute, a sharp distinction is made between those properties constructed and capitalized before the passage of the law, and the new roads built since that time. For all new construction of independent roads the commission applies an arbitrary scale of costs which seems to be sufficiently liberal to allow for promoters' profits, seasoning of the property, and even a certain value for the franchise. But great hardship has arisen in the application of the law either to old roads or to extensions and improvements attempted by these older properties. So evident did it become that an entirely different mode of treatment was necessary for the two classes of railroads, that the law was amended in 1901 so as to permit the separate and independent capitalization of extensions, regardless of the over-capitalization of the main stem.

The prime result contemplated by the Texas authorities being to impose a check upon over-capitalization, it is beyond question that this has been attained. How rigid the limitations were may be instanced by the case of the Houston and Texas Central. Between 1892 and 1906 the length of this road expanded from 507 to 694 miles, while the total capitalization was actually reduced by about $1,000,000; that is to say, the average stocks and bonds per mile of line dropped from $50,900 to $35,700. Similar results followed all over the state. Between 1894 and 1906

the railway mileage in Texas increased by about one fourth, to a total of 12,058 miles. The stocks and bonds outstanding per mile of line during these thirteen years dropped from $40,802 to $31,530. This result so ardently desired by the advocates of the law was, it must be said, somewhat nullified during the last ten years of the period in question by an increase of floating debt from $30,300,000 to $76,500,000. The ominous significance of this growth of current liabilities lay in the fact of the commission's flat refusal to permit it to be refunded. This is obviously the logical application of the law, namely, not even to permit the increased valuation of the property due to improvements of any sort to be paid for by new securities until the outstanding capitalization has been brought down to the limits of the actual investment. The situation is paradoxical enough, with railroad properties continually increasing in worth and earning capacity but accompanied by a steady decline both in the volume and, it may be added, the market prices of their shares.

One effect of the restrictive Texas law has, then, undoubtedly been to penalize improvements and betterment. Considerable new construction, as we have seen, has taken place; but, on the other hand, the speculative or even the dishonest promoter has by no means been eliminated. The recent Frisco scandals were largely concerned with the over-capitalization of Texas branch lines. The most serious result, however, is the discouragement of improvements such as the substitution of heavy rails for light, the replacement of wooden structures with steel, the reduction of grades, better stations, etc. The strict policy of the commission has been somewhat relaxed since 1907 in case of equipment security issues. And, as above mentioned, the independent capitalization of extensions is permitted. But a heavy hand still rests upon all bond issues for betterment of the existing lines of the older companies. The fact seems to be ignored that a close interrelation obtains between the amount of the investment and current operating cost.[41] Consequently, in the absence of large additions to plant, the level of operating expenses stands so high that little or no net earnings remain. In 1906, twenty-three of the fifty-five railroads in Texas reported a deficit.[42] Under such circumstances whatever new capital for improvements was imperatively demanded has had to be raised by the use of collateral trust bonds, issued upon their

[41] Ripley, *Railroads: Rates and Regulation,* p. 66.

[42] *Railway Age Gazette,* 1903, p. 106; and especially 1913, p. 1151, "Hearings before the Texas Welfare Commission."

own superior credit by parent railroads outside the state although secured by the assets of Texas lines.[43]

The conclusion is unavoidable that people resident in other states have furnished Texas with transportation for which it does not pay. The antiquated physical valuations used as a standard for capitalization also fail to recognize the degree to which the growth of the country has tended in itself to bring the volume of securities outstanding into accord with the present worth of the investment. Physical valuations as a consequence stand far below the assessments for purposes of taxation. It appears that the development of the country has already automatically "squeezed" much of the water out of its railroad capitalization; and that economic conditions are now ripe for the inauguration of a more liberal policy in future.

The Texas law seems to demand amendment in such a manner as to release the railroad commission from the arbitrary and exacting mathematical requirements of the statute; and to permit it, like the New York commissions, to exercise a reasonable discretion in authorizing railroads to issue securities for all legitimate purposes. It seems probable also that the law is theoretically defective in seeking to prevent all stock-watering in connection with new construction. This point is indeed indirectly conceded, as we have already seen, by the liberal way in which construction costs are measured. Texas, above all things, stands in need of transportation development by reason of its vast area. The discouragement to prospective investors is almost abject. It is certain that not only the issue of bonds at a discount, but even resort to stock bonuses in order to promote the sale of bonds, may at times be necessary in order to procure an adequate supply of new capital under the risks attendant upon pioneering.[44] But, whatever one may think about stock-watering as a necessary concomitant of construction, the Texas experience clearly demonstrates that a drastic attempt within a brief period to correct all the excesses of the past,[45] may so completely discourage enterprise in the present as to militate against the public interest.

[43] *U. S. Railroad Securities Commission,* p. 30. *Cf.* the Pecos Valley line. The Pecos Valley branch of the Santa Fé system is partly in Texas, partly in New Mexico. The I.C.C. found in a rate case the former capitalized at $8,000 per mile, the latter $42,000, with no difference in actual cost. *Railway Age Gazette,* LVI (1914), p. 322.

[44] *Cf.* Commissioners Meyer and Knapp, *Hearings on Rate Increases,* III (1910), p. 2513.

[45] *Cf.* p. 549 *supra* on the attempt in reorganization proceedings in New

The regulation of capitalization by other states than those already described has been too brief to call for extended comment. Wisconsin has in a measure manifested an interest in this aspect of affairs, since 1907; but so far as railroads are concerned the supervision of security issues is quite perfunctory. The first law merely called for the filing of data, after which the commission was required to certify the issue. But the law was amended in 1911 by providing that stocks or bonds should be limited to the amounts reasonably necessary for the purposes stated. Authority was conferred upon the commission to determine whether these purposes were lawful and whether the amount was, in fact, reasonable. But no occasion has yet arisen calling for a formal decision or opinion. This is somewhat extraordinary in view of the fact that the total number of stock and bond authorizations for all classes of public service companies for the six years since 1907 amounts to 670—an average of about 100 cases a year.

The record of the recently created New Jersey commission is more positive. A number of suggestive principles have already been laid down in the course of two years' experience. Thus it was held in a case of over-capitalization as a result of merger, whereby practically half of the securities outstanding were based upon "anticipation rather than solid assets," that the company could not set up its capitalization or its contracts as a bar to the state's exercise of power over rates.[46] Offerings of securities, as in New York, must be publicly made in order to afford an opportunity for the company to realize the best possible price.[47] Equipment trust bonds may not be sold at favorable prices based upon their high standing as "purchase-money mortgages" unless, as a matter of fact, new equipment is really acquired by this means.[48] Mortgage indebtedness aggregating possibly three times the capital stock departs so radically from the old-established principle that loans ought not to exceed assets, that the New York Central refunding mortgages in 1913 were disapproved as to property

York and Nebraska to scale down excessive past issues by prohibiting an exchange par for par.

[46] Public Service Gas Company, December 26, 1912. Affirmed by the New Jersey Supreme Court, June, 1913. "The ultimate question is a question of business and the results cannot be predicted. In such a case the commissioners ought to move with caution. We think in this case they have done so."

[47] North Hudson County Railway case, Dec. 5, 1913.

[48] Public Service Railway Company, Mar. 3, 1914.

within the state of New Jersey.[49] On the other hand, the fundamental principle is clearly enunciated that regulation implies protection against competition as a necessary corollary. It is against the public interest to permit two monopolies, both subject to regulation, to invade one another's territory.[50] The record of this New Jersey commission, although short, seems likely to entitle it to a commanding position among administrative boards of this type in the United States.

A few additional cases from other parts of the country indicate certain significant tendencies. The contrast in attitude toward construction between the well-settled East and the undeveloped territory in the West is striking. The general need of transportation facilities in the latter case renders it particularly difficult to resist the temptation to admit newcomers regardless of consequences. In other words, the settled policy in the East of recognizing and protecting transportation as a local monopoly is far less rigidly applied. Thus in Nebraska,[51] although the commission by constitutional amendment may disapprove of competition, invasion of already occupied territory is not forbidden, on the ground that it "involves such grave responsibility that the commission will not exercise it unless specifically directed so to do by the legislature."

In California such competition in invading virgin territory is obviated by the device applied to the Northwestern Pacific Railroad of an equally divided ownership of stock between the Atchison and the Southern Pacific.[52] But, it appearing that $35,000,000 of stock at par is carried on the books of these companies at only $7,600,000, a physical valuation of the property is demanded as a prerequisite for further bond issues. There is no evidence, however, of a disposition to imitate the rigorous Texas plan of expunging this watered stock before permitting further issues for construction. A more positive restraint in another California

[49] Decision, Dec. 19, 1913.

[50] New Jersey Power Company, decided January 27, 1914. Well expressed for New York in the repeated refusal by the up-state commission to permit the financing of trolley lines parallelling the New York Central from Buffalo to the Hudson River. 3 P.S.C. 2d D.(N. Y., 1913) 55.

Marked liberality in treatment is also manifested in the allowance of capitalization of expenses of development. This is unique. *Cf.* P.S.C.(N. Y., 1912), 246, allowing 30 per cent of the capitalization for the special value of "plant with a business attached."

[51] *Railway Commission, Sixth Ann. Rep.* (1913), p. 255.

[52] Railroad Commission, 1914, decision no. 1428.

case is manifest.[53] A railway petitioned for $15,000,000 at par of bonds to complete construction. The road was evidently needed; but, in view of the stated evil of overissue of bonds, authority was granted to substitute for the above-mentioned issue, $10,000,000 in bonds and $3,000,000 in stock at par instead. This attempt to maintain a due relation between capital stock and indebtedness recalls the above-mentioned Nebraska case which permitted a similar over-weight of bonds, but only on the ground that no other financial plan was feasible.[54]

Another recent case, in Missouri,[55] affords an interesting example of all of the abuses of construction company finance of the classical sort. Frank disapproval of these practices is, however, coupled with the submission of a well-ordered plan by which the road may be honestly built. The powers and intelligence of the Michigan commission are now on trial in disentangling the involved finances of the Père Marquette road. Refusal by this body to allow issue of short-term notes against a deposit of bonds as collateral on such terms as to create a much greater liability than the loan represented, precipitated a receivership.

The course of events in recent years, despite the activity of the several states in regulating capitalization, has emphasized the need of legislation in this field by the federal government. Several bills are now before Congress upon the subject. This federal interest in capitalization has in part arisen from the ever-increasing complexity of inter-corporate relation. Few railroads now confine their activity within the boundaries of a single state. The several scandals incident to the late collapse of the New Haven, the Rock Island, and the Frisco systems, each of them widely interstate in character, have demonstrated the need of federal interference. From the railroad point of view, also, the desirability of an enlargement of the scope of authority of the Interstate Commerce Commission has been established through the well nigh intolerable conflict of authority of the many public

[53] Railroad Commission, 1914, decision no. 1264.

[54] *Cf.* the New Jersey disapproval, heretofore cited, of the New York Central bonds; and, on the other hand, the amendment of Massachusetts law in 1913 permitting bonds to thrice the amount of capital stock, instead of twice as formerly.

[55] P.S.C.(1913)141. The prohibtion of any loans by the construction company based upon deposit of the railroad stock, until the property is actually created, closes the door to such abuses as occurred in the Hampden case in Massachusetts. *Railway Age Gazette,* LVI (1914), p. 1180.

service commissions and state courts now at work in this field.[56] No fewer than six different state commissions are said to be taking a hand in the pending reorganization of the Wabash. The approval of each is necessary for validation of the plans, and it is impossible to obey so many masters. It is also daily becoming more clear that the conflict of state and federal authority in the regulation of rates can be averted only by the assumption of unified financial control by the United States.[57] Rates, service, and finance are so completely interlocked that satisfactory regulation in each field cannot be exercised except by the assumption of full authority over all three domains alike.

The foregoing recital of the causes of federal interest in control of capitalization seems to dispose summarily of the recommendations of the Railroad Securities Commission of 1910 in favor of a conservative policy of mere publicity. It would appear as if, in order to relieve the carriers from the conflicting and sometimes harassing exercise of power by the different state boards, the only course would be to confer equally broad powers upon the Interstate Commerce Commission. Otherwise the state commissions might not be retired from the field. This, likewise, is the principal objection to a plan of control intermediate between mere publicity and strict regulation.[58] The prevention of issuance of securities for improper purposes, and of immoral profits to insiders, as well as a guarantee that all moneys raised shall be rightly expended for the public good, might conceivably be brought about through a greater concentration of responsibility upon directors. They might be required, for example, to subscribe to a full and sworn statement on the corporate minutes as to these details and thereafter be made criminally liable at law. Did not the state commissions, endowed with much broader discretionary authority over the issuance of securities, already exist, this plan might have much to recommend it. At all events it would do away with such dummy directors as were used by the Mellen

[56] *Cf.* the conflict of laws in the New Haven case in 1908 respecting validation of securities in Massachusetts of a corporation chartered in Connecticut (198 Mass. 413). The Validation Act of 1910 was a necessary consequence.

But the Supreme Court decision in the Shreveport case, just rendered, considerably clarifies the situation.

[57] Ripley, *Railroads: Rates and Regulation,* ch. 20.

[58] *Railway Age Gazette,* LVI, 1914, p. 62. Embodied in H. R. 13454 presented by Mr. Esch of Wisconsin. It provides for the issuance of a certificate of notification. A bill for positive regulation is embodied in H. R. 12584.

administration of the New Haven road in the cases of the Billard Company and other subsidiary corporations.[59]

But these state commissions can hardly be expected or required to withdraw from the field unless an equal measure of authority is conferred by Congress upon the Interstate Commerce Commission.[60] The advantage of singleness of purpose and uniformity of treatment certainly attaches to such assumption by the United States of the present functions of the different commonwealths. Evasion of control, now so prevalent under the present system of divided responsibility would be brought to an end. And, finally, it now appears that the objection brought forward by the federal Securities Commission, that public opinion would not support the assertion of exclusive federal jurisdiction, no longer holds good. Whether at the same time federal incorporation is desirable would seem to be more problematical.[61] But it is clear that the time has now arrived when certainty and simplification of control in the interest of all parties concerned, can be secured in no other way.

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[59] Investigation by the Interstate Commerce Commission in May, 1914, to be embodied in a report to the Senate.

[60] The remedy of an interchange of views between federal and state boards as a means of securing harmony, illustrated in respect of safety appliances and standardization of accounts, fails at this point.

[61] Railroad Securities Commission, p. 25.